
FINANCIAL SECTION

for Fiscal Year ending June 30, 2006

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INDEPENDENT AUDITOR'S REPORT

Board of Trustees
Teachers' Retirement System of the State of Kentucky
Frankfort, Kentucky

We have audited the accompanying statements of plan net assets of the Teachers' Retirement System of the State of Kentucky as of June 30, 2006 and 2005 and the related statements of changes in plan net assets for the years then ended. These component unit financial statements are the responsibility of the Teachers' Retirement System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the general purpose financial statements referred to above present fairly, in all material respects, the plan net assets of the Teachers' Retirement System of the State of Kentucky, a component unit of the Commonwealth of Kentucky, at June 30, 2006 and 2005 and the changes in its plan net assets for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated December 5, 2006 on our consideration of the Teachers' Retirement System of the State of Kentucky's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 15-18 are not a required part of the basic financial statements but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplemental information. However, we did not audit the information and express no opinion on it.

The financial section supporting schedules listed in the table-of-contents are presented for the purpose of additional analysis and are not a required part of the basic financial statements. These schedules are the responsibility of the System's management. Such schedules as of and for the year ended June 30, 2006 have been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, are fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

We did not audit the data included in the Introductory and Statistical sections of the report and therefore express no opinion on them.

Charles T. Mitchell Co.

December 5, 2006

MANAGEMENT'S DISCUSSION AND ANALYSIS

This discussion and analysis of Kentucky Teachers' Retirement System's financial performance provides an overview of the defined benefit and medical insurance plans' financial year ended June 30, 2006. Please read it in conjunction with the respective financial statements, which begin on page 19.

USING THIS FINANCIAL REPORT

Because of the long-term nature of a defined benefit pension plan and medical insurance plan, financial statements alone cannot provide sufficient information to properly reflect the plan's ongoing plan perspective. The Statement of Plan Net Assets and Statement of Changes in Plan Net Assets (on pages 19-20) provide information about the activities of the defined benefit plan, medical insurance plan, and the tax-sheltered annuity plan as a whole. The Kentucky Teachers' Retirement System is the fiduciary of funds held in trust for its members.

The Schedule of Funding Progress (on pages 37-38) includes historical trend information about the actuarially funded status of each plan from a long-term, ongoing plan perspective and the progress made in accumulating sufficient assets to pay benefits and insurance premiums when due. The Schedule of Employer Contributions (on pages 38-39) presents historical trend information about the annual required contributions of employers and the contributions made by employers in relation to the requirement. These schedules provide information that contributes to understanding the changes over time in the funded status of the plans.

KENTUCKY TEACHERS' RETIREMENT SYSTEM AS A WHOLE

In the fiscal year ended June 30, 2006, Kentucky Teachers' Retirement System's combined plan net assets increased by \$315.7 million - from \$13,667.8 million to \$13,983.5 million. The following summaries focus on plan net assets and changes in plan net assets of Kentucky Teachers' Retirement System's defined benefit plan, medical insurance plan, and the tax-sheltered annuity plan.

KENTUCKY TEACHERS' RETIREMENT SYSTEM

Summary of Plan Net Assets (In Millions)

Categories	Defined Benefit Plan			Medical Insurance Plan			TOTAL *		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
Cash & Investments	\$14,632.5	\$14,144.4	\$13,486.8	\$132.1	\$153.3	\$159.7	\$14,764.6	\$14,297.7	\$13,646.5
Receivables	94.7	110.0	162.9	7.1	2.3	2.7	101.8	112.3	165.6
Capital Assets	3.2	3.3	3.4				3.2	3.3	3.4
Total Assets	\$14,730.4	\$14,257.7	\$13,653.1	\$139.2	\$155.6	\$162.4	\$14,869.6	\$14,413.3	\$13,815.5
Total Liabilities	(879.0)	(737.7)	(733.5)	(7.6)	(8.3)	(5.8)	(886.6)	(746.0)	(739.3)
Plan Net Assets	\$13,851.4	\$13,520.0	\$12,919.6	\$131.6	\$147.3	\$156.6	\$13,983.0	\$13,667.3	\$13,076.2

*For the 403(b) Tax Shelter Plan cash and investments were approximately \$.5 million for the years ended 2006 and 2005; and \$.6 million for year 2004.

Summary of Changes In Plan Net Assets (In Millions)

Categories	Defined Benefit Plan			Medical Insurance Plan			TOTAL		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
ADDITIONS									
Member Contributions	\$258.5	\$247.0	\$238.9	\$51.7	\$51.6	\$52.1	\$310.2	\$298.6	\$291.0
Employer Contributions	410.9	388.3	382.3	89.3	79.0	53.3	500.2	467.3	435.6
Investment Income (net)	717.3	946.1	1,158.2	6.8	6.5	7.1	724.1	952.6	1,165.3
Other Income				6.1			6.1		
TOTAL ADDITIONS	\$1,386.7	\$1,581.4	\$1,779.4	\$153.9	\$137.1	\$112.5	\$1,540.6	\$1,718.5	\$1,891.9
DEDUCTIONS									
Benefit Payments	\$1,035.6	\$963.4	\$885.3				\$1,035.6	\$963.4	\$885.3
Refunds	12.9	11.0	10.5				12.9	11.0	10.5
Administrative Expense	6.8	6.6	6.6	4.6	4.1	3.9	11.4	10.7	10.5
Insurance Expenses				165.0	142.3	117.5	165.0	142.3	117.5
TOTAL DEDUCTIONS	\$1,055.3	\$981.0	\$902.4	\$169.6	\$146.4	\$121.4	\$1,224.9	\$1,127.4	\$1,023.8
Increase (Decrease) in Plan Net Assets	\$331.4	\$600.4	\$877.0	(\$15.7)	(\$9.3)	(\$8.9)	\$315.7	\$591.1	\$868.1

Plan net assets of the defined benefit plan increased by 2.45% (\$13,851.4 million compared to \$13,520 million). The increase is primarily due to continued favorable market conditions which resulted in a net investment gain of \$717.3 million. These assets are restricted to providing monthly retirement allowances to members and their beneficiaries.

Plan net assets of the medical insurance plan decreased by 10.7% (\$131.6 million compared to \$147.3 million) primarily due to insurance expense increases. Plan assets are restricted to providing hospital and medical insurance benefits to members and their spouses.

DEFINED BENEFIT PLAN ACTIVITIES

Member contributions increased \$11.5 million. Retirement contributions are calculated by applying a percentage factor to salary and are paid monthly by each member. Members may also pay contributions to repurchase previously refunded service credit or to purchase various types of elective service credit.

Employer contributions totaled \$410.9 million, a net increase of \$22.6 million over the 2005 fiscal year.

The System experienced another gain in net investment, although the gain was less than the previous year (\$717.3 million gain at June 30, 2006 as compared to a \$946.1 million gain at June 30, 2005). The increase in the fair value of investments is mainly due to continued favorable market conditions for the year ended June 30, 2006, yet in comparison the market was not as strong as the year ended June 30, 2005. This can be illustrated as follows:

(In Millions)			
	2006	2005	2004
Appreciation (depreciation) in fair value of investments – June 30, prior year	\$ 610.4	\$ 171.4	\$ (361.6)
Appreciation (depreciation) in fair value of investments – June 30, end of year	<u>690.4</u>	<u>610.4</u>	<u>171.4</u>
Change in net appreciation (depreciation) in fair value of investments	80.0	439.0	533.0
Net income (net of investment expense)	434.8	433.8	395.0
Net gain on sale of investments	<u>202.5</u>	<u>73.3</u>	<u>230.2</u>
Investment Income (net) – June 30, end of year	\$ 717.3	\$ 946.1	\$1,158.2

Program deductions in 2006 increased \$74.3 million. The increase was caused principally by an increase of \$72.2 million in benefit payments. Members who were drawing benefits as of June 2005 received an increase of 2.2% to their retirement allowances in July 2005. Also, there was an increase of 1,095 members and beneficiaries on the retired payroll as of June 30, 2006.

MEDICAL INSURANCE PLAN ACTIVITIES

During the 2006 fiscal year, member contributions increased \$.1 million and employer contributions increased by \$10.3 million over fiscal year 2005. The employer contributions increased primarily because \$62.3 million in stabilization funding was placed in the medical insurance fund from the pension fund at the recommendation of the system's actuary. The amount will be repaid over a ten-year period per KRS 161.553. The employer contribution was based on a .75% allocation of employer contributions as compared to 1.77% for fiscal year 2005.

Program deductions increased \$23.2 million due to an increase of insurance expenses of \$22.7 million. The monthly premium subsidy for retirees under age 65 increased 19.3% effective January 1, 2006 with a decrease of 11.6% mandated by the legislature to become effective July 1, 2006. The monthly premium subsidy for retirees age 65 and over increased 9.4%. The increases in monthly insurance premiums for retirees under age 65 were \$20.7 million. The increases in medical claims for retirees age 65 and older were \$1.9 million.

Net investment income increased \$.3 million from \$6.5 million in 2005 to \$6.8 million in 2006. This is due to the recognition of interest income since all investments for the Medical Insurance Plan are short term in nature and the recognition of appreciation in fair value is not feasible. This can be illustrated as follows:

(In Millions)	<u>2006</u>	<u>2005</u>	<u>2004</u>
Appreciation in fair value of investments – June 30, prior year			
Appreciation in fair value of investments – June 30 end of year	\$ 0	\$ 0	\$ 0
Net appreciation in fair value of investments	<u>0</u>	<u>0</u>	<u>0</u>
Net income (net of investment expense)	0	0	0
Net gain on sale of investments	6.8	6.5	7.1
Investment Income (net) – June 30	<u>0</u>	<u>0</u>	<u>0</u>
	\$ 6.8	\$ 6.5	\$ 7.1

HISTORICAL TRENDS

Accounting standards require that the statement of plan net assets state asset value at fair value and include only benefits and refunds due plan members and beneficiaries and accrued investment and administrative expenses as of the reporting date. Information regarding the actuarial funding status of the defined benefit plan and the medical insurance plan is provided in the Schedule of Funding Progress (beginning on page 37). The asset value, stated in the Schedule of Funding Progress, is determined by the System's independent actuary. The actuarial accrued liability is calculated using the projected unit credit cost method.

The 2006 fiscal year reveals a decline in funding position due to declining financial markets and an increase in actuarial liability. Even under these adverse conditions, the defined benefit plan continues to be well funded.

The medical insurance plan is not as vulnerable to adverse market conditions since its assets are all short term in nature and less likely to experience huge fluctuations. Although, the plan continues to have a large unfunded actuarial liability, the current obligations are being met by current funding.

Annual required contributions of the employers in relation to the required contributions are provided in the Schedule of Employer Contributions (on page 38). This schedule indicates that employers are generally meeting their responsibilities to provide resources to the plans.

FINANCIAL SECTION

Statement of Plan Net Assets As of June 30, 2006 and 2005

	Defined Benefit Plan		Medical Insurance Plan		403(b) Tax Shelter		TOTAL	
	2006	2005	2006	2005	2006	2005	2006	2005
ASSETS								
Cash	\$9,629,298	\$10,007,055					\$9,629,298	\$10,007,055
Prepaid expenses	96,544	111,389					96,544	111,389
Receivables								
Contributions	29,953,514	25,496,774	\$1,118,926	\$2,267,944			31,072,440	27,764,718
State of Kentucky	5,673,887	19,217,940					5,673,887	19,217,940
Investment income	58,321,829	59,206,811			\$ 71	\$ 46	58,321,900	59,206,857
Investment sales receivable	0	5,150,651					0	5,150,651
Installment account receivable	734,673	946,715					734,673	946,715
Medicare D receivables			5,999,560				5,999,560	
Other receivables	59,932	23,165					59,932	23,165
Total receivables	94,743,835	110,042,056	7,118,486	2,267,944	71	46	101,862,392	112,310,046
Investments, at fair value (See Note 4)								
Short term investments	661,700,340	1,133,906,547	132,083,928	153,361,225	515,732	532,228	794,300,000	1,287,800,000
Bonds and mortgages	4,185,201,899	4,269,791,312					4,185,201,899	4,269,791,312
Common stock	8,531,993,656	7,612,197,454					8,531,993,656	7,612,197,454
Real estate	387,193,796	386,004,453					387,193,796	386,004,453
Total investments	13,766,089,691	13,401,899,766	132,083,928	153,361,225	515,732	532,228	13,898,689,351	13,555,793,219
Invested security lending collateral	856,631,934	732,378,811					856,631,934	732,378,811
Capital assets, at cost net of accumulated depreciation of \$1,764,597 (See Note 2)	3,180,032	3,283,385					3,180,032	3,283,385
Total assets	14,730,371,334	14,257,722,462	139,202,414	155,629,169	515,803	532,274	14,870,089,551	14,413,883,905
LIABILITIES								
Liabilities								
Accounts payable	1,713,031	1,229,294					1,713,031	1,229,294
Treasurer's unredeemed checks	13,823	11,809					13,823	11,809
Insurance claims payable			7,580,738	8,312,899			7,580,738	8,312,899
Compensated absences payable	601,135	604,988					601,135	604,988
Revenues collected in advance			7,391	5,376			7,391	5,376
Investment purchases payable	20,000,000	3,499,614					20,000,000	3,499,614
Obligations under securities lending	856,631,934	732,378,811					856,631,934	732,378,811
Total liabilities	878,959,923	737,724,516	7,588,129	8,318,275	0	0	886,548,052	746,042,791
Net assets held in trust for pension & post-employment healthcare benefits: (See Required Supplemental Schedule 1 for a schedule of funding progress.)	\$13,851,411,411	\$13,519,997,946	\$131,614,285	\$147,310,894	\$515,803	\$532,274	\$13,983,541,499	\$13,667,841,114
The accompanying notes are an integral part of these financial statements.								

KENTUCKY TEACHERS' RETIREMENT SYSTEM

**Statement of Changes in Plan Net Assets
For the Years Ended June 30, 2006 and 2005**

	Defined Benefit Plan		Medical Insurance Plan		403(b) Tax Shelter		TOTAL	
	2006	2005	2006	2005	2006	2005	2006	2005
ADDITIONS								
Contributions								
Employer	\$410,920,969	\$388,346,438	\$89,319,498	\$79,022,562			\$500,240,467	\$467,369,000
Member	258,464,856	247,024,518	51,697,167	51,576,031			310,162,023	298,600,549
Total contributions	669,385,825	635,370,956	141,016,665	130,598,593	0	0	810,402,490	765,969,549
Other Contributions								
Recovery income			118,419				118,419	
Medicare D receipts			5,999,560				5,999,560	
Total other contributions			6,117,979				6,117,979	
Investment Income								
Net Appreciation/(Depreciation) in FV of Investments	282,572,648	512,314,384					282,572,648	512,314,384
Interest	255,566,732	242,566,500	6,804,286	6,507,537	\$ 21,454	\$ 11,479	262,392,472	249,085,516
Dividends	153,566,960	162,040,978					153,566,960	162,040,978
Rental Income, Net	30,949,900	33,121,604					30,949,900	33,121,604
Securities Lending, Gross Earnings	28,464,668	18,152,354					28,464,668	18,152,354
Gross Investment Income	751,120,908	968,195,820	6,804,286	6,507,537	21,454	11,479	757,946,648	974,714,836
Less Investment Expense	(6,156,584)	(4,670,256)					(6,156,584)	(4,670,256)
Less Securities Lending Expense	(27,656,322)	(17,455,008)					(27,656,322)	(17,455,008)
Net Investment Income	717,308,002	946,070,556	6,804,286	6,507,537	21,454	11,479	724,133,742	952,589,572
Total additions	1,386,693,827	1,581,441,512	153,938,930	137,106,130	21,454	11,479	1,540,654,211	1,718,559,121
DEDUCTIONS								
Benefits	1,035,606,281	963,371,539			37,925	39,877	1,035,644,206	963,411,416
Refunds of contributions	12,834,222	10,975,941	5,143	9,072			12,839,365	10,985,013
Insurance expenses			165,006,322	142,349,436			165,006,322	142,349,436
Administrative expense	6,839,859	6,652,673	4,624,074	4,070,892			11,463,933	10,723,565
Total deductions	1,055,280,362	981,000,153	169,635,539	146,429,400	37,925	39,877	1,224,953,826	1,127,469,430
Net increase (decrease)	331,413,465	600,441,359	(15,696,609)	(9,323,270)	(16,471)	(28,398)	315,700,385	591,089,691
Net assets held in trust for pension & post employment healthcare benefits								
Beginning of year	13,519,997,946	12,919,556,587	147,310,894	156,634,164	532,274	560,672	13,667,841,114	13,076,751,423
Ending of year	<u>\$13,851,411,411</u>	<u>\$13,519,997,946</u>	<u>\$131,614,285</u>	<u>\$147,310,894</u>	<u>\$515,803</u>	<u>\$532,274</u>	<u>\$13,983,541,499</u>	<u>\$13,667,841,114</u>
<i>The accompanying notes are an integral part of these financial statements.</i>								

Notes to Financial Statements

Years Ended June 30, 2006 and 2005

Note 1: Description of Plan

A. REPORTING ENTITY

The Teachers' Retirement System of the State of Kentucky (KTRS) was created by the 1938 General Assembly and is governed by Chapter 161 Section 220 through Chapter 161 Section 990 of the Kentucky Revised Statutes (KRS). KTRS is a blended component unit of the Commonwealth of Kentucky and therefore is included in the Commonwealth's financial statements. KTRS is a cost-sharing multiple-employer defined benefit plan established to provide pension benefit plan coverage for local school districts and other public educational agencies in the state.

B. PARTICIPANTS

As of June 30, 2006 a total of 199 employers participated in the plan. Employers are comprised of 176 local school districts, 17 Department of Education Agencies and other educational organizations, 5 universities and also the Kentucky Community and Technical College System.

According to KRS 161.220 " . . . any regular or special teacher, or professional occupying a position requiring certification or graduation from a four (4) year college or university . . . " is eligible to participate in the System. The following illustrates the classifications of members:

Active contributing members:	<u>2006</u>	<u>2005</u>
Vested	41,656	40,799
Non-vested	32,084	31,482
Inactive members, vested	4,275	4,033
Retirees and beneficiaries currently receiving benefits	<u>38,497</u>	<u>37,402</u>
Total members, retirees, and beneficiaries	116,512	113,716

C. BENEFIT PROVISIONS

Members become vested when they complete five (5) years of credited service. To qualify for monthly retirement benefits, payable for life, members must either:

- 1.) Attain age fifty-five (55) and complete five (5) years of Kentucky service, or
- 2.) Complete 27 years of Kentucky service.

Note 1: Description of Plan continued . . .

Participants that retire before age 60 with less than 27 years of service receive reduced retirement benefits. Non-university members receive monthly payments equal to two (2) percent (service prior to July 1, 1983) and two and one-half (2.5) percent (service after July 1, 1983) of their final average salaries for each year of credited service. University employees receive monthly benefits equal to two (2) percent of their final average salary for each year of credited service. The final average salary is the member's five (5) highest annual salaries except members at least 55 with 27 or more years of service may use their (3) three highest annual salaries. New members (including second retirement accounts started) after July 1, 2002 will receive monthly benefits equal to 2% of their final average salary for each year of service if, upon retirement, their total service is less than ten years. New members after July 1, 2002 who retire with ten or more years of total service will receive monthly benefits equal to 2.5% of their final average salary for each year of service, including the first ten years. In addition, members who retire July 1, 2004 and later with more than 30 years of service will have their multiplier increased for all years over 30 from 2.5% to 3.0% to be used in their benefit calculation.

The system also provides disability benefits for vested members at the rate of sixty (60) percent of the final average salary. A life insurance benefit, payable upon the death of a member, is \$2,000 for active contributing members and \$5,000 for retired or disabled members.

Cost of living increases are one and one-half (1.5) percent annually. Additional ad hoc increases, and any other benefit amendments must be authorized by the General Assembly.

Note 2: Summary of Significant Accounting Policies

A. BASIS OF ACCOUNTING

The financial statements are prepared on the accrual basis of accounting. Member contributions and employer matching are recognized in the fiscal year due. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

B. CASH

KTRS has three cash accounts. At June 30, 2006, the pension cash account totaled \$7,406,251; the administrative expense fund cash account was \$1,902,091; and the life insurance cash account totaled \$320,956; therefore, the carrying value of cash was \$9,629,298 and the corresponding bank balance was \$12,307,142. The variance is primarily due to outstanding checks and items not processed by the bank on June 30, 2006.

C. CAPITAL ASSETS

Fixed assets are recorded at historical cost less straight-line accumulated depreciation. The classes of fixed assets are furniture and equipment, the KTRS office buildings and land. Furniture and equipment are depreciated over an average useful life of five to seven years. The office buildings are depreciated over forty years.

Note 2: Summary of Significant Accounting Policies continued . . .

D. INVESTMENTS

Plan investments are reported at fair value. Fair value is the amount that a plan can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller. Short-term securities are carried at cost, which approximates fair value. Fixed income and common and preferred stocks are generally valued based on published market prices and quotations from national security exchanges and securities pricing services. Real estate is primarily valued based on appraisals performed by independent appraisers.

Purchase and sales of debt securities, equity securities, and short-term investments are recorded on the trade date. Real estate equity transactions are recorded on the settlement date. Upon sale of investments, the difference between sales proceeds and cost is reflected in the statement of changes in plan net assets.

Investment expenses consist of investment manager and consultant fees along with fees for custodial services.

E. COMPENSATED ABSENCES

Expenses for accumulated vacation days and compensatory time earned by the System's employees are recorded when earned. Upon termination or retirement, employees of the system are paid for accumulated vacation time limited to 450 hours and accumulated compensatory time limited to 200 hours. As of June 30, 2006 and 2005 accrued compensated absences were \$601,135 and \$604,988.

F. RISK MANAGEMENT

Destruction of assets, theft, employee injuries and court challenges to administrative policy are among the various risks to which the system is exposed. In order to cover such risks the system carries appropriate insurance policies such as fire and tornado, employee bonds, fiduciary liability, worker's compensation and equipment insurance.

G. OTHER RECEIVABLES

KTRS now allows qualified purchases of service credit to be made by installment payments not to exceed a five-year period. Revenue is recognized in the initial year of the installment contract agreement. The June 30, 2006 and 2005 installment contract receivables were \$734,673 and \$946,714.

H. USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

I. INCOME TAXES

The defined benefit plan is organized as a tax-exempt retirement plan under the Internal Revenue Code. The tax sheltered annuity plan is no longer continued and will be fully terminated when all lifetime annuities have expired. The system's management believes that it has operated the plans within the constraints imposed by federal tax law.

Note 2: Summary of Significant Accounting Policies continued . . .

J. ACCOUNTING CHANGES

The system opted for early implementation of GASB #44 Economic Condition Reporting: The Statistical Section as of June 30, 2005. See the statistical section for these disclosures.

Note 3: Contributions and Reserves

A. CONTRIBUTIONS

Contribution rates are established by Kentucky Revised Statutes. Members are required to contribute 9.855% of their salaries to the System. University members are required to contribute 8.375% of their salaries. KRS 161.580 allows each university to reduce the contribution of its members by 2.215%; therefore, university members contribute 6.16% of their salary to KTRS.

The Commonwealth of Kentucky is required to contribute 13.105% of salaries for its non-university members and 13.84% of salaries for university members.

The member and employer contributions consist of pension contributions and post-retirement contributions. The post-retirement contribution .75% finances KTRS' retiree medical insurance plan.

If an employee leaves covered employment before accumulating five (5) years of credited service, accumulated employee contributions plus interest are refunded to the employee upon the member's request.

B. RESERVES

Member Reserve

This fund was established by KRS 161.420(2) as the Teacher Savings Fund and consists of contributions paid by university and non-university members. The fund also includes interest authorized by the Board of Trustees from Unallocated Reserves. The accumulated contributions of members that are returned upon withdrawal or paid to the estate or designated beneficiary in the event of death are paid from this fund. Upon retirement, the member's contributions and the matching state contributions are transferred from this fund to Benefit Reserves, the fund from which retirement benefits are paid.

Employer Reserve

This fund was established by KRS 161.420(3) as the State Accumulation Fund and receives state appropriations to the Retirement System. The state matches an amount equal

to members' contributions. State appropriations during the year are based on estimates of members' salaries. At year-end when actual salaries are known, the required state matching is also realized by producing either a receivable from or a payable to the State of Kentucky. While fiscal years 2006 and 2005 resulted in over-appropriations from the state a receivable is still due from the state because prior years under-appropriations have not been paid.

Benefit Reserve

This fund was established by KRS 161.420(4) as the Allowance Reserve Fund, the source for retirement, disability, and survivor benefits paid to members of the System. These benefits are paid from the retired members' contributions until they are exhausted, at which time state matching contributions are used to pay the benefits. After an individual member's contributions and the state matching contributions have been exhausted, retirement benefits are paid from monies transferred from Unallocated Reserves.

Unallocated Reserve

This fund was established by KRS 161.420(6) as the Guarantee Fund to collect income from investments, state matching contributions of members withdrawn from the System, and state matching contributions for cost of living adjustments (COLAs). In addition, it receives money for which disposition is not otherwise provided. This fund provides interest to the other funds, benefits in excess of both members' and state matching contributions, monies for administrative expenses of the System, and deficiencies not covered by the other funds.

Administrative Expense Reserve

This fund was established by KRS 161.420(1) as the Expense Fund. Investment income transferred to this fund from Unallocated Reserves is used to pay the administrative expenses of the System.

Life Insurance Reserve

This fund was established pursuant to the provisions of KRS 161.655 to provide a life insurance benefit to retired and active members of the Kentucky Teachers' Retirement System. This benefit is financed by KTRS employer contributions that are actuarially determined.

**Note 4: Deposits With Financial Institutions and Investments
(Including Repurchase Agreements)**

A. LEGAL PROVISIONS FOR INVESTMENTS

The following disclosures are meant to help the users of KTRS' financial statements assess the risks KTRS takes in investing public funds. The Board of Trustees and the Investment Committee are guided by asset allocation parameters that the Board approves through its powers defined in KRS 161.430. The parameters as outlined in Title 102, Chapter 1.175, Section 2 of the Kentucky Administrative Regulations are as follows:

- ⌞ There shall be no limit on the amount of investments owned by the System that are guaranteed by the U.S. Government.
- ⌞ Not more than thirty-five percent (35%) of the assets of the System at book value shall be invested in corporate debt obligations.
- ⌞ Not more than sixty percent (60%) of the assets of the System at book value shall be invested in common stocks or preferred stocks. Not more than twenty-five percent (25%) of the assets of the System at book value shall be invested in a stock portfolio designed to replicate a general, United States stock index.
- ⌞ Not more than ten percent (10%) of the assets of the System at book value shall be invested in real estate. This would include real estate equity, real estate lease agreements, mortgages on real estate that are not guaranteed by the U.S. Government, and shares in real estate investment trusts.
- ⌞ Not more than one percent (1%) of the assets of the System at book value shall be invested in venture capital investments, providing at least seventy-five percent (75%) of such investments must be in-state.
- ⌞ Not more than ten percent (10%) of the assets of the System book value shall be invested in any additional category or categories of investments. The Board of Trustees shall approve by resolution such additional category or categories of investments. Within this parameter, to further diversify the portfolio, the Board approved provisions that permit the limited ownership of both foreign equities and timberland.

B. CASH AND CASH EQUIVALENTS

For cash deposits and cash equivalents, custodial credit risk is the risk that, in the event of a bank failure, the retirement system's deposits may not be returned to the system. The System's total bank balance at June 30, 2006 was \$12,307,142, of which \$3,945,250 primarily represents deposited amounts due the System for which actual funds are in transit to and waiting to be received by the custodial bank; therefore, these funds were unavailable for investment. An additional amount of \$1,902,091 represents funds held in the bank but their

Note 4: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

investment is controlled by the Commonwealth of Kentucky. The remaining bank balance amount of \$6,459,802 was the amount invested in cash equivalents. Cash equivalents are created through the daily sweeps of available excess cash by the System's custodial bank into bank sponsored short-term investment funds. These funds are custodial bank sponsored commingled funds which are invested in short-term securities backed by the U.S. Government and its agencies. The actual cash deposits held in bank accounts are insured up to \$100,000 as covered by federal depository insurance and uncollateralized until being invested in cash equivalents.

Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are:

- a. uncollateralized,
- b. collateralized with securities held by the pledging financial institution, or
- c. collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name.

As of June 30, 2006 the System's cash equivalents in the amount of \$6,459,802 were not exposed to custodial credit risk since this amount was invested by the custodial bank and collateralized at 102% with the collateral pledged to the Treasurer of the Commonwealth of Kentucky.

C. INVESTMENTS

All of the System's assets are invested in short-term and long-term debt (bonds and mortgages) securities, equity securities, and real estate. These assets are reported at fair market value.

Investments are governed by the Board of Trustees' policy while the Board of Trustees and the Investment Committee shall execute their fiduciary responsibilities in accordance with the "prudent person rule", as identified in KRS 161.430 (2)(b). The prudent person rule establishes a standard for all fiduciaries, to act as a prudent person would be expected to act, with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims".

The following chart represents the fair market values of the investments of the Kentucky Teachers' Retirement System for June 30, 2006.

KENTUCKY TEACHERS' RETIREMENT SYSTEM

Note 4: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

Schedule of Investments		
	June 30, 2006	June 30, 2005
Short Term Investments		
Repurchase Agreements	\$ 794,300,000	\$ 1,287,800,000
Total Short Term Investments	\$ 794,300,000	\$ 1,287,800,000
Bonds and Mortgages		
U.S. Government Obligations		
Treasury Notes & Bonds	\$ 1,032,439,779	\$ 1,224,201,754
Agencies	1,039,092,693	1,150,974,690
GNMA (Single Family)	18,781,578	39,496,335
Other Miscellaneous	<u>168,353,243</u>	<u>130,140,221</u>
Total U.S. Government Obligations	\$ 2,258,667,293	\$ 2,544,813,000
Corporate Bonds		
Industrial	\$ 542,410,465	\$ 591,007,453
Finance	1,023,985,966	886,000,915
Utility Bonds (Except Telephone)	119,160,317	112,350,505
Telephone Bonds	<u>46,512,518</u>	<u>80,660,662</u>
Total Corporate Bonds	\$ 1,732,069,266	\$ 1,670,019,535
Other Fixed Income Investments		
FHA and VA Single Family Mortgages	\$ 1,904	\$ 6,526
Project Mortgages (FHA & GNMA)	13,687,213	18,317,771
State and Local Government Issues	<u>180,776,223</u>	<u>36,634,480</u>
Total Other Investments	\$ 194,465,340	\$ 54,958,777
Total Bonds and Mortgages	\$ 4,185,201,899	\$ 4,269,791,312
Stocks	\$ 8,531,993,656	\$ 7,612,197,454
Real Estate	<u>387,193,796</u>	<u>386,004,453</u>
Total Investments	\$ 13,898,689,351	\$ 13,555,793,219
<i>This Schedule does not include \$856,631,934 securities lending collateral.</i>		

Custodial Credit Risk

Custodial Credit Risk for an investment is the risk that, in the event of the failure of counterparty, the pension trust fund will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the retirement system, and are held by either:

- a. the counterparty or
- b. the counterparty's trust department or agent, but not in the System's name.

Note 4: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

The cash reserve of the System is maintained in high quality short-term investments. Commercial paper, U.S. Treasury and agency obligations, certificates of deposit, banker's acceptances, and repurchase agreements are all permissible investments. The System utilized investment instruments it regards as the most secure and having the best returns and does not use short-term investments that finance foreign businesses unless they are issued and guaranteed by the United States Government.

Individual repurchase agreements are ordered by KTRS under the terms of Master Repurchase Agreements with various brokers under terms dictated by KTRS. The repurchase agreements and their supporting collateral are held by the custodial agent's correspondent bank in an account identified by the custodian's name and KTRS's nominee name. This account is unique to KTRS. The Master Repurchase Agreements require that the supporting collateral have a market value of at least 102% of the value of the repurchase agreements.

In addition to the System's \$13.9 billion in investments at June 30, 2006, cash collateral reinvestment securities acquired through securities lending by the System's custodian, whom is also the lending agent/counterparty amounted to \$856,631,934. This is consistent with the System's securities lending agreement with the custodian. (Please refer to a following section entitled Securities Lending.)

Interest Rate Risk

Interest Rate Risk on investments is the possibility that changes in interest rates will reduce the fair value of the retirement System's investments. In general, the longer the period until an investment matures, the greater the negative impact that changes in interest rates can have on fair value.

As of June 30, 2006 KTRS had the following investments and weighted average maturities:

<u>Investment Type</u>	<u>Fair Value</u>	<u>Average Maturity (years)</u>
U.S. Treasuries	\$ 1,065,908,866	10.6
Agencies	1,039,092,693	10.0
Corporate Bonds	1,732,069,266	8.3
Mortgage Pass-Throughs	32,470,695	21.9
State & Local Govt Issues	180,776,223	13.4
Collateralized Mortgage Obligations	<u>134,884,156</u>	<u>21.6</u>
Totals	\$ 4,185,201,899	10.1

KENTUCKY TEACHERS' RETIREMENT SYSTEM

Note 4: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

In addition to the above securities, Repurchase Agreements (short-term investments) had a total fair value of \$794,300,000 average maturity of 5.8 days. Average maturity is used as a measure of a security's exposure to interest rate risk due to fluctuations in market interest rates. Mortgage pass-throughs and collateralized mortgage obligations are typically amortizing investments with an average life and interest rate risk, significantly less than suggested by the legal maturity. Mortgage-backed securities, which are generally pre-payable, and other callable bonds are subject to adverse changes in average life in response to market interest rate changes. The preceding schedule reflects only the legal maturity of all such bonds.

The System does not have a formal investment policy that limits investment maturities as a means of managing its exposure to potential fair value losses arising from future changes in interest rates. Market or interest rate risk is the greatest risk faced by an investor in the debt securities market. The price of a debt security typically moves in the opposite direction of the change in interest rates. Mortgages held by the System are fixed interest rate mortgages.

Collateralized mortgage obligations (CMOs) are bonds that are collateralized by whole loan mortgages, mortgage pass-through securities or stripped mortgage-backed securities. Income is derived from payments and prepayments of principal and interest generated from collateral mortgages. Cash flows are distributed to different investment classes in accordance with a CMO's established payment order. The System held \$134.9 million in CMOs as of June 30, 2006.

Asset-backed securities (ABS) are bonds or notes backed by loan paper or accounts receivable originated by banks, credit card companies, or other credit providers. The originator of the loan or accounts receivable paper sells it to a specially created trust, which repackages it as securities. ABSs have been structured as pass-throughs and as structures with multiple bond classes. The ABSs held by the system and reported in the corporate bond category above are moderately sensitive to changes in interest rates.

Credit Risk

Credit risk is the risk that an issuer or counterparty to an investment will not fulfill its obligations. The following schedule lists KTRS's investments according to credit ratings as of June 30, 2006:

<u>RATING</u>	<u>FAIR VALUE</u>
Repurchase Agreements	\$ 794,300,000
Agency	1,207,379,658
AAA	556,659,829
AA	506,148,069
A	697,167,296
BBB	139,535,548
BB	24,175,953
Total	\$ 3,925,366,353

Note 4: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

Total market value of the fixed income portfolio was \$4,979,501,899 on June 30, 2006. In addition to the above investments, there were securities owned totaling \$1,054,135,546 in U.S. Treasury Issues, which are obligations of the U.S. Government. The rating system used in the chart is the nationally recognized Standard and Poor's rating system. The credit risk associated with repurchase agreements and Agency investments is very minimal as the general rating of these securities is higher than AAA. Notation is made that the ratings of securities is subject to change due to circumstances and thereby may have a lower rating than when first purchased.

The System's policy on credit rating as stated in 102 KAR 1:175 is that:

"A fixed income investment shall be rated at the time of purchase within the four (4) highest credit classifications identified by one (1) of the major rating services. A private placement debt investment shall be subject to the same credit qualifications as each fixed income investment. Notwithstanding the foregoing, the fixed income investment portfolio as a whole shall maintain an average rating equal to at least the second highest credit classification."

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. Losses from credit risk are heightened if a significant portion of resources are invested with a single issuer. Per Administrative Regulation 102 KAR 1:175, the System is subject to the following policies regarding single issuers of fixed income and equity securities:

"Unless the issuer is the United States Government or one (1) of its agencies, the amount invested in the securities of a single issuer shall not equal more than five (5) percent of the assets of the system at book value."

"The System's position in a single stock shall not exceed two (2) percent of the System's assets at book value. The system's position in a single stock shall not exceed five (5) percent of the outstanding stock for that company unless the investment is part of a venture capital program approved by the Board of Trustees or the Investment Committee."

KTRS has not invested greater than five percents (5%) of the System's assets at book value in any single issuer and is in compliance with the System's policies as stated here.

Foreign Currency Risk

As of June 30, 2006, KTRS had no exposure to foreign currencies.

Any stocks held associated with foreign interest are American Depositary Receipt (ADR) investments which are securities that are issued by a U.S. bank in place of the foreign stock shares held in trust by that bank, thereby facilitating the trading of foreign shares in U.S. markets. ADRs are denominated in U.S. currency.

KENTUCKY TEACHERS' RETIREMENT SYSTEM

Note 4: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

The System's policy regarding foreign equities is that "Not more than 10% of the assets of the System at book value shall be invested in any additional category or categories of investments....Within this parameter, to further diversify the portfolio, the Board approved provisions that permit the limited ownership of both foreign equities and timberland."

D. SECURITIES LENDING

Section 161.430 of the Kentucky Revised Statutes empowers the Board of Trustees with complete fiduciary responsibility for the funds of the System. The System operates a securities lending program in which it temporarily lends securities to qualified agents in exchange for a net fee and high quality collateral. U.S. Government and agency securities and selected domestic stocks and bonds are the types of securities that are lent. The System's sub-custodian, The Bank of New York, acts as lending agent in exchanging securities for collateral. The collateral has a value of not less than 102% of the market value of the lent securities plus any accrued, unpaid distributions. The collateral may consist of cash, marketable U.S. Government securities, and select marketable U.S. Government agency securities approved by the System.

Securities lending transactions are accounted for in accordance with GASB Statement No. 28 Accounting and Financial Reporting for Securities Lending Transactions, which established standards of accounting and financial reporting for securities lending transactions. The following section details the net income earned from securities lending for the fiscal year ended June 30, 2006:

<u>ITEM</u>	<u>EARNINGS</u>
Gross Earnings (Interest and fees)	\$ 28,464,668
Less: Gross Borrower Rebates	27,315,764
Bank Fees	340,558
Other	0
Net Earnings	<u>\$ 808,346</u>

Note 4: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

Cash collateral is invested in short-term obligations fully guaranteed by the United States Government or select Government agencies and Government Repurchase Agreements with qualified agents. The System cannot pledge or sell collateral securities received unless the borrower defaults. The lending agent (Bank of New York) also indemnifies the System from any financial loss associated with a borrower's default and collateral inadequacy. As of June 30, 2006 the loan maturity was one day and the weighted average maturity of cash collateral investments was one day.

At fiscal year end, the System has no credit risk exposure to borrowers, since the amounts the System owes the borrowers exceeds the amounts the borrowers owe the System and there were no losses resulting during the period.

Security lending programs can entail interest rate risk and credit risk. The System minimizes interest rate risk by limiting the term of cash collateral investments to several days. The credit risk is controlled by investing cash collateral in securities with qualities similar to the credit worthiness of lent securities.

The following table presents the fair values of the underlying securities, and the value of the collateral pledged at June 30, 2006:

Type of Security Lent	Fair Value	Cash Collateral Received Non-Cash Collateral Value*
U.S. Government and Agencies	\$ 548,168,691	\$ 556,988,665
U.S. Equities	294,729,093	299,643,269
TOTAL	\$ 842,897,784	\$ 856,631,934

**Represents value of cash collateral only. Loan or margin collateral requirements met via the use of non-cash collateral (e.g. Government securities or Letters of Credit) are excluded from these values.*

Note 5: Medical Insurance Plan & Post-Employment Benefits

A. PLAN DESCRIPTION

In addition to the required pension benefits described in Note 1, Kentucky Revised Statute 161.675 allows KTRS to provide post-retirement healthcare benefits to members and dependents. To be eligible for medical benefits, the member must have retired either for service or disability, attain age 55 with 5 years of Kentucky service or had 27 years of Kentucky service.

The KTRS self-insured plan is limited to KTRS members and spouses at least the age of 65. All KTRS members under the age of 65 are offered commercial insurance through a state insurance purchasing pool administered by the Kentucky Personnel Cabinet. The Personnel Cabinet's primary function is to negotiate contracts with health plans to obtain the best price for persons covered. KTRS members were given a supplement to be used for payment of their health insurance premium. The amount of the member's supplement was based on the member's service credit and age. Premiums over the monthly supplement are paid by the member. The system bears no risk for excess claims expenses under the commercial insurance coverage.

KTRS members and spouses at least age 65 in the KTRS self-insured plan are also given a supplement based on service credit. Members with 20 or more years of service received the highest supplement.

At June 30, 2006, KTRS insurance covered 30,601 retirees and 6,520 dependents.

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The Medical Insurance Plan financial statements are prepared using the accrual basis of accounting. Member contributions and employer matching are recognized in the fiscal year due. Healthcare premiums charged to retired members are recognized when due and any premiums collected in advance are recognized as a liability.

Method Used to Value Investments

Since the investments are all short-term investments they are reported at cost, which approximates fair value.

C. CONTRIBUTIONS

The post-retirement healthcare provided by KTRS is financed on a pay-as-you-go basis. In order to fund the post-retirement healthcare benefit, one and five tenths percent (1.5%) of the gross annual payroll of all active members is contributed. One-half (1/2) of this amount is

Note 5: Medical Insurance Plan & Post-Employment Benefits continued . . .

derived from member contributions and one-half (1/2) from state appropriation. Also, the premiums collected from retirees as described in the plan description help meet the medical expenses of the plan.

Since medical expenses have skyrocketed in the last decade, it has become increasingly difficult to meet the expenses of the retiree health insurance program. To fund the plan, the state legislature has directed Medical Insurance Stabilization Funding of \$62,294,800 and \$29,169,700 for fiscal years 2006 and 2005 respectively. These amounts are to be repaid to the System's guarantee fund from the State's general fund over a 10 year period per KRS 161.553.

D. INCURRED BUT NOT REPORTED CLAIMS LIABILITIES

July 1, 1991 KTRS became self-insured assuming all liability for post-retirement healthcare costs. Effective January 1, 1997, insurance plan participants under age 65 were offered insurance through a state purchasing pool. KTRS recognizes estimates of liabilities for self-insured unpaid claims that have incurred (both reported and unreported) using the development method. This method uses past observed patterns of time between the date the claim is incurred and the date the claim is paid to estimate incurred claims from available paid claim information. The following schedule shows the change in the claims and liability and the claims activity for the years ended June 30, 2006 and 2005.

	Fiscal Year 2006	Fiscal Year 2005
Beginning Unpaid Claims Liability	\$ 8,312,898	\$ 5,798,772
Claims Incurred		
Current Year	166,148,844	140,105,734
Increase (Decrease) in Prior Years	<u>(1,142,811)</u>	<u>2,243,702</u>
Total Incurred Claims	\$ 165,006,034	\$ 142,349,436
Claims Paid		
Current Year	\$ 160,549,717	\$ 133,632,780
Prior Years	<u>5,188,476</u>	<u>6,202,530</u>
Total Payments	\$ <u>165,738,193</u>	\$ <u>139,835,310</u>
Ending Unpaid Claims Liability	\$ 7,580,738	\$ 8,312,898

E. ADMINISTRATIVE EXPENSES

The total administrative expenses of \$4,624,074 are processing fees paid to third party administrators.

Note 6: 403(b) Tax-Sheltered Annuity Plan

A. PLAN DESCRIPTION

KTRS has, in prior years, administered a salary deferral program as permitted by section 403(b) of the Internal Revenue Code. Under this program members were able to voluntarily defer a portion of their compensation within the limits established by the applicable laws and regulations. However, the System's Board of Trustees determined that the cost of providing the necessary services to assure the System of continuing compliance with these laws and regulations was not economically feasible due to the limited participation in the program by the System's members. The Board decided, therefore, to discontinue offering the program as of April 30, 1997. Members who were not receiving annuities from their account as of April 30, 1997, were able to transfer their respective accounts directly into other tax-sheltered plans on a tax-free basis. As of June 30, 2006, the thirty-two members who are receiving annuities will continue to receive distributions according to the terms of their respective elections.

B. SUMMARY OF SIGNIFICANT POLICIES

Basis of Accounting

The Tax-sheltered Annuity Plan financial statements are prepared using an accrual basis of accounting. Contributions are no longer being accepted into the plan, therefore, there are no receivables to be recognized.

Method Used to Value Investments

The short-term investments are reported at cost, which approximates fair value.

Note 7: Pension Plan for Employees of the System

Full-time employees of Kentucky Teachers' Retirement System (KTRS) participate in either KTRS or Kentucky Employees Retirement System. Both plans are multiple-employer cost sharing defined benefit pension plans. All KTRS employees in positions requiring a four-year degree are covered under KTRS. The contribution rates and required employer matching are the same as state agency employers in the system. These rates, the plan description and funding policy are fully disclosed in the notes to the financial statements.

The System's annual required contributions for KTRS employee members for the fiscal years 2006, 2005, and 2004 were \$368,662, \$355,095, and \$359,370 respectively. KTRS contributed 100% of the required contribution each year.

All other KTRS employees are covered under the Kentucky Employee Retirement System (KERS) in the Non-Hazardous Employees Pension Plan. The plan provides for retirement, disability, and death benefits to plan members. Retirement benefits may be extended to

Note 7: Pension Plan for Employees of the System continued ...

beneficiaries of plan members under certain circumstances. Per KRS 61.565(3), contribution rates shall be determined by the Board on the basis of an annual actuarial valuation. Rates may be amended by the Board as needed. The System's administrative budget and employer contribution rates are subject to the approval of the Kentucky General Assembly. Employee contribution rates are set by the statute and may be changed only by the Kentucky General Assembly.

Members of KERS were required to contribute 5% of their annual creditable compensation for the fiscal years 2006, 2005, and 2004. As the employer, KTRS is required to contribute the annual actuarially determined rate of the creditable compensation. The actuarial rate for the fiscal years 2006, 2005, and 2004 was 5.89%; and the System's annual required contributions to KERS were \$103,137, and \$268,975, and \$123,483 respectively. KTRS contributed 100% of the required contributions for each year.

KERS issues a publicly available financial report that may be obtained by writing Kentucky Retirement System, 1260 Louisville Road, Frankfort, Kentucky 40601-6124.

Required Supplementary Schedules

Required Supplemental Schedule Defined Benefit Plan Schedule of Funding Progress (dollar amounts in millions)

VALUATION YEAR JUNE 30	ACTUARIAL VALUE OF ASSETS	ACTUARIAL ACCRUED LIABILITIES	UNFUNDED ACTUARIAL ACCRUED LIABILITIES (UAAL)	FUNDED RATIO	COVERED PAYROLL	UAAL AS A % OF COVERED PAYROLL
	a	b	(b-a)	(a/b)	c	[(b-a)/c]
2001	\$ 13,299.2	\$ 14,642.1	\$ 1,342.9	90.8%	\$ 2,213.8	60.7%
2002	13,588.8	15,695.6	2,106.8	86.6	2,313.7	91.1
2003	13,863.8	16,594.8	2,731.0	83.5	2,497.7	109.3
2004	14,255.1	17,617.6	3,362.5	80.9	2,641.5	127.3
2005	14,598.8	19,134.8	4,536.0	76.3	2,703.4	167.8
2006	14,857.6	20,324.7	5,467.1	73.1	2,859.5	191.2

The amounts reported in this schedule of funding progress do not include assets or liabilities for post-employment healthcare benefits, nor are the assets and liabilities of the tax-sheltered annuity plan included.

**Required Supplemental Schedule
Defined Benefit Plan
Schedule of Employer Contributions
(dollar amounts in millions)**

FISCAL YEAR ENDED JUNE 30	ANNUAL REQUIRED CONTRIBUTIONS	PERCENTAGE CONTRIBUTED
2001	\$ 262.8	100 %
2002	284.8	100
2003	322.0	100
2004	364.4	100
2005	383.8	100
2006	406.1	100

**Required Supplemental Schedule
Medical Insurance Plan
Schedule of Funding Progress
(dollar amounts in millions)**

VALUATION YEAR JUNE 30	ACTUARIAL VALUE OF ASSETS	ACTUARIAL ACCRUED LIABILITIES	UNFUNDED ACTUARIAL ACCRUED LIABILITIES (UAAL)	FUNDED RATIO	COVERED PAYROLL	UAAL AS A % OF COVERED PAYROLL
	a	b	(b-a)	(a/b)	c	[(b-a)/c]
2001	\$ 103.4	\$ 2,531.0	\$ 2,427.6	4.1 %	\$ 2,213.8	109.7%
2002	146.0	2,806.0	2,660.0	5.2	2,313.7	115.0
2003	165.5	2,886.0	2,720.5	5.7	2,497.7	108.9
2004	158.9	3,166.6	3,007.7	5.0	2,641.5	113.9
2005	147.3	4,763.9	4,616.6	3.1	2,703.4	170.8
2006	131.6	4,341.9	4,210.3	3.0	2,859.5	147.2

The amounts reported in this schedule of funding progress do not include assets or liabilities for the defined benefit plan, nor are the assets and liabilities of the tax-sheltered annuity plan included.

**Required Supplemental Schedule
Medical Insurance Plan
Schedule of Employer Contributions
(dollar amounts in millions)**

FISCAL YEAR ENDED JUNE 30	ANNUAL REQUIRED CONTRIBUTIONS	PERCENTAGE CONTRIBUTED
2001	\$ 92.4	100%
2002	95.3	100
2003	77.2	100
2004	53.3	100
2005	79.0	100
2006	89.3	100

Notes to Required Supplementary Information

Note 1: Description of Schedule of Funding Progress

Defined Benefit Plan

The schedule of Funding Progress summarizes the actuarial value of the System's assets and actuarial accrued liability as of June 30, 2006, and each of the preceding five years. The data presented in the schedule were obtained from the System's independent actuary's annual valuation report for each year presented.

Expressing the actuarial value of assets as a percentage of the actuarial accrued liabilities provides an indication whether the system is becoming financially stronger or weaker. Generally, the greater the percentage the stronger the retirement system. Trends in unfunded actuarial accrued liabilities and annual covered payroll are both affected by inflation. Expressing the unfunded actuarial accrued liabilities as a percentage of annual covered payroll aids analysis of progress made in accumulating sufficient assets to pay benefits when due. Generally, the smaller this percentage the stronger the retirement system.

Medical Insurance Plan

The schedule of Funding Progress summarizes the actuarial value of the System's assets and actuarial accrued liability as of June 30, 2006 and each of the preceding five years. The data presented in the schedule were obtained from the System's independent actuary's annual valuation report for each year presented.

Expressing the actuarial value of assets as a percentage of the actuarial accrued liabilities provides an indication whether the system is becoming financially stronger or weaker. Generally, the greater the percentage the stronger the plan. Trends in unfunded actuarial accrued liabilities and annual covered payroll are both affected by inflation. Expressing the unfunded actuarial accrued liabilities as a percentage of annual covered payroll aids analysis of progress made in accumulating sufficient assets to pay benefits when due. Generally, the smaller this percentage the stronger the plan.

Note 2: Actuarial Methodologies and Assumptions

DEFINED BENEFIT PLAN

A. Methodologies

The promised benefits of the System are included in the actuarially calculated contribution rates, which are developed using the unit credit actuarial cost method with projected benefits. The actuarial value of assets was determined using the method illustrated in the Actuarial Value of Assets table. Gains and losses are reflected in the unfunded accrued liability that is being amortized by regular annual contributions as a level percentage of payroll within a 30-year period using an open amortization approach. The five (5) year smoothed market approach is used for asset valuation.

Actuarial Value of Assets		
(1)	Actuarial Value of Assets on June 30, 2005	\$ 14,598,842,537
(2)	Market Value End of Year June 30, 2006	13,783,830,173
(3)	Market Value Beginning of Year June 30, 2005	13,456,025,741
(4)	Cash Flow	
	a. Contributions	664,572,122
	b. Benefit Payments	<u>1,037,706,643</u>
	c. Net	(373,134,521)
(5)	Investment Income	
	a. Market total: (2) - (3) - (4)c	700,938,953
	b. Assumed rate	7.5%
	c. Amount for Immediate Recognition [(1) x (5)b] + [(4)c*(5)b*0.5]	1,080,920,646
	d. Amount for Phased-in Recognition (5)a - (5)c	(379,981,693)
(6)	Phased-in Recognition of Investment Income	
	a. Current Year: 0.20*(5)d	(75,996,339)
	b. First Prior Year	(23,843,540)
	c. Second Prior Year	(349,147,545)
	d. Third Prior Year	0
	e. Fourth Prior Year	<u>0</u>
	f. Total Recognized Investment Gain	(448,987,424)
(7)	Actuarial Value End of Year June 30, 2006 (1) + (4)c + (5)c + (6)f	14,857,641,238
(8)	Difference Between market & Actuarial Values (2) - (7)	(1,073,811,065)

B. Assumptions

Significant actuarial assumptions employed by the actuary for the funding purposes as of June 30, 2006, the most recent updated actuarial information include:

* Assumed inflation rate	4.0%
* Assumed investment rate	7.5%
* Assumed projected salary increases	4.0% - 8.2%
* Assumed post retirement benefit increase	1.5%

Note 2: Actuarial Methodologies and Assumptions continued . . .

MEDICAL INSURANCE PLAN

A. Methodologies

The actuarial value of assets is determined by using the market value as provided by KTRS. Compliance with applicable current or future accounting standards may require use of different actuarial methods or assumptions. For purposes of estimating the amortization, a 4.0% salary scale is used.

B. Assumptions

Significant actuarial assumptions employed by the actuary for the funding purposes as of June 30, 2006, the most recent updated actuarial information include:

Investment Rate of Return*	7.50%
Healthcare cost trend rate*	
Initial Pre-Medicare trend rate	11.50%
Initial Post-Medicare trend rate	11.30%
Ultimate Pre-Medicare trend rate	5.00%
Year of Ultimate Pre-Medicare trend rate	2013
Ultimate Post-Medicare trend rate	5.00%
Year of Ultimate Post-Medicare trend rate	2012
<i>*Includes inflation at</i>	4.00%

Supporting Schedule 1
Schedule of Administrative Expenses
Year Ended June 30, 2006

ADMINISTRATIVE EXPENSES	YEAR ENDED JUNE 30, 2006
Salaries	\$ 4,890,745
Other Personnel Costs	446,613
Professional Services & Contracts	229,853
Utilities	66,842
Rentals	17,143
Maintenance	74,460
Postage & Related Services	351,646
Printing	151,241
Insurance	77,020
Miscellaneous Services	98,899
Telecommunications	27,493
Computer Services	47,975
Supplies	49,906
Depreciation	141,629
Travel	41,871
Dues & Subscriptions	26,128
Miscellaneous Commodities	7,187
Furniture, Fixtures, & Equipment not Capitalized	97,061
Compensated Absences	<u>(3,853)</u>
TOTAL ADMINISTRATIVE EXPENSES	\$ 6,839,859

Supporting Schedule 2

Schedule of Contracted Investment Management Expenses
Year Ended June 30, 2006

BALANCED MANAGER

Todd Investment Advisors	\$	1,125,000
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FIXED INCOME MANAGERS

Galliard Capital Management		313,207
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EQUITY MANAGERS

GE Asset Management Inc.	\$	647,328
UBS Global Asset Management Corporation		970,000
Wellington Management Company,LLP		2,501,832
Total Equity Managers		4,119,160

CUSTODIAN

Farmers Bank		492,668
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CONSULTANT

Becker, Burke Associates		65,000
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TOTAL CONTRACTED INVESTMENT MANAGEMENT EXPENSES

\$	6,115,035
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Supporting Schedule 3

Schedule of Professional Fees for Year Ended June 30, 2006

PROFESSIONAL	NATURE OF SERVICE	YEAR ENDED JUNE 30, 2006
Charles T. Mitchell Company, LLP	Auditing Services	\$ 28,000
Cavanaugh Macdonald Consulting	Actuarial Services	172,860
Reed, Weitkamp, Schell & Vice, PLLC	Attorney Services	3,080
Farmers Bank	Banking Services	15,755
International Claim Specialist	Investigative Services	10,158
	TOTAL	\$ 229,853

Charles T. Mitchell Company, LLP

Certified Public Accountants

WILLIAM G. JOHNSON, JR., C.P.A.

JAMES CLOUSE, C.P.A.

BERNADETTE SMITH, C.P.A.

KIM FIELD, C.P.A.

GREG MIKLAVCIC, C.P.A.

Consultants

CHARLES T. MITCHELL, C.P.A.

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**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL
REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

Board of Trustees
Teachers' Retirement System of the State of Kentucky
Frankfort, Kentucky

We have audited the general purpose financial statements of Teachers' Retirement System of the State of Kentucky, a component unit of the Commonwealth of Kentucky, as of and for the year ended June 30, 2006, and have issued our report thereon dated December 5, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Teachers' Retirement System of the State of Kentucky's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statement and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance

As part of obtaining reasonable assurance about whether Teachers' Retirement System of the State of Kentucky's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our test disclosed no instances on noncompliance that are required to be reported under Government Auditing Standards.

This report is intended for the information of the audit committee, management, and federal awarding agencies and pass-through entities. However, this report is a matter of public record and its distribution is not limited.

Charles T. Mitchell Co.

December 5, 2006